BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of	)	
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Implementation of the Telecommunications Act of 1996	)	
	)	
Accounting Safeguards Under the Telecommunications Act of 1996	)	CC Docket No. 96-150
	)	

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REPLY COMMENTS OF SBC COMMUNICATIONS INC.

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CC Docket No. 96-150

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SUMMARY*

The Commission need not expand or modify the accounting safeguards. In fact, price regulation and competition have rendered the accounting safeguards obsolete as a method of preventing cross-subsidy at the expense of LECs' regulated service ratepayers. Thus, the Commission should either eliminate or streamline the accounting safeguards. However, to the extent the Commission declines to do so, it should leave them as they are.

Focusing on cross-subsidy, the Commission should reject arguments that go beyond the scope of the proceeding or which are intended to serve the commenter's own anticompetitive interests. As a means of preventing cross-subsidy, the existing accounting safeguards are effective. RHC diversification under the interLATA and manufacturing relief granted by the 1996 Act is not a basis to require any strengthening of the accounting safeguards. The Commission's vigilant and vigorous auditing efforts demonstrate that the comprehensive accounting safeguards have worked well in protecting LECs' ratepayers.

Special allocation rules are not needed for incidental interLATA services because Section 271(h) activities that are nonregulated for Title II accounting purposes under the Joint Cost Order's criteria will bear their proper share of joint and common costs pursuant to Part 64 cost allocation principles. To the extent regulated activities are involved, they will be subject to existing Title II regulation such as separations and tariff procedures. To those who seek a video dialtone style of accounting regulation, Congress' response is reflected in its repeal of VDT

* The abbreviations used in this Summary are the same as those used in the text of the Reply Comments.

regulation.

Those commenters that advocate adoption of additional and more detailed affiliate transaction rules, such as elimination of the prevailing price method and super-imposition of fair market value study requirements for affiliate services, have not succeeded in meeting the "heavy burden" that the Commission established in the NPRM. In contrast, the LEC industry has provided extensive evidence of the intrusive, onerous and unnecessary burdens and vast problems that the NPRM's proposed changes would create. Commenters supporting the NPRM's proposed changes have not provided any basis to conclude that it is reasonable and consistent with minimizing the burden of regulation to throw out the objective prevailing price method in favor of a subjective process for estimating fair market value. Rather than provide factual support for these proposed changes, the commenters merely echo the NPRM's unsupported concerns in an unconvincing fashion. There are ample reasons, identified by SBC and other commenters, for avoiding the use of subjective fair market value studies as a basis for valuing affiliate services.

Non-LEC commenters such as AT&T and APCC favor retention of the prevailing price method, recognizing its advantages over the use of estimated fair market value. In fact, in arguing against the 75% threshold proposed in the Affiliate Transaction NPRM, AT&T argued that a prevailing price was reliable if "a significant group of customers buys a good or service at a certain price from an unregulated affiliate of AT&T." The Commission should minimize the burden of its regulation by not imposing an arbitrary threshold.

The Commission should not adopt accounting safeguards or rules that would require a BOC to discriminate against its Section 272 affiliate. The Commission should also reject suggestions to impose other detailed accounting or audit requirements that are entirely unnecessary, such as excessive detail in CAM filings or a litany of guidelines for conducting the biennial Section 272 audits.

The purpose of the accounting safeguards would not be served by applying them to transactions between the Section 272 affiliate and all other BOC affiliates. The purpose of the accounting safeguards is to protect ratepayers of a LEC's regulated services, not to protect subscribers of a competitive, start-up long distance company. The IXCs' arguments in favor of this redundant regulation are blatant attempts to bridle their potential competitors with unnecessary restraints to ensure their own continued success in the interLATA marketplace. Section 272 affiliates, like their competitors, must have the freedom to design their accounting systems and charts of accounts in a manner best suited to their business functions consistent with GAAP. The IXCs claim that applying Part 32 accounting rules to the Section 272 affiliate will facilitate auditing. This is a grossly insufficient reason to impose burdensome regulation on the competitive affiliates. The inapplicability of Part 32 and other accounting safeguards to the internal books of other affiliates has never impaired the Commission's ability to audit affiliate transactions with the LECs.

Contrary to the complaints of the RHCs' competitors, now is not the time to shackle the BOCs' procompetitive entry into new markets by reverting to more intensive forms of outmoded regulation of earnings, costs and arbitrary allocations of joint and common costs.

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REPLY COMMENTS OF SBC COMMUNICATIONS INC.

In these Reply Comments, SBC Communications Inc. ("SBC")[1] demonstrates why the Commission's accounting safeguards need not be expanded or modified in the manner suggested in the NPRM or by some commenters to fulfill the requirements of the 1996 Act consistent with its directive to avoid unnecessary regulation.[2] In fact, while these Reply Comments focus primarily on the arguments of commenters who seek to have the Commission intensify its accounting safeguard regulation, SBC's initial Comments demonstrated why prevention of

[1] SBC Communications Inc. ("SBC"), one of the Regional Bell holding companies ("RHCs"), files these Reply Comments by its attorneys and on behalf of its subsidiaries, including Southwestern Bell Telephone Company ("SWBT"), Southwestern Bell Communications Services, Inc. ("SBCS"), and Southwestern Bell Mobile Systems, Inc. ("SBMS").

[2] WorldCom is the only commenter that seriously questions the NPRM's attention to minimizing the burden of unnecessary regulation and its imposition of a "heavy burden" on those seeking increased regulation. WorldCom at 8-9. WorldCom has not understood the deregulatory, procompetitive message embodied in the 1996 Act, as explained in SBC's Comments. SBC at 2-5.

cross-subsidy no longer requires use of cost allocation rules and other accounting safeguards.[3] Accordingly, to the extent the Commission retains the accounting safeguards, it should streamline them as much as possible.[4]

I. A NUMBER OF ARGUMENTS GO BEYOND THE SCOPE OF THE PROCEEDING.

This proceeding should focus on the intended purpose of the Commission's existing accounting safeguards: to prevent cross-subsidy[5] at the expense of LECs' regulated ratepayers. The Commission should not be distracted by commenters that wish to link this proceeding to other objectives or that wish to use this proceeding to establish a barrier to effective competition.

Interexchange carriers ("IXCs") urge the Commission to pursue a number of objectives that are unrelated to the prevention of cross-subsidy. Some of the IXCs' suggestions are blatant attempts to shape the accounting safeguards to suit their own anticompetitive purposes, such as the suggestions that the Commission should require public disclosure of the Section 272 (and other) affiliates' financial statements, earnings and profits.[6] While this highly proprietary

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[3] SBC at 5-10 & passim.

[4] See USTA at 13-15 and Attachment (proposed text of streamlined Part 32/64 Rules).

[5] The meaning of "cross-subsidy" in academic literature, and as used herein, is pricing for an indefinite period at a level below the incremental cost of providing a service. See generally Areeda & Turner, Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88 Harvard L. Rev. 697 (1975).

[6] AT&T at 18; MCI at 27-28; TRA at 8; WorldCom at 29. Going far beyond the audit-related requirements of the 1996 Act, AT&T suggests that all BOC affiliates must issue separate financial statements for public review on a quarterly basis. There is no justification whatsoever for requiring publication of each and every one of the BOC's competitive affiliate's financial statements. To the extent a Commission audit needs such highly proprietary data for legitimate purposes in connection with an audit, the auditor can review it on a confidential basis. The

financial data would be especially useful as an anticompetitive weapon for IXCs that have the vast majority of the interLATA market, it would have little or no value for purposes of accounting safeguards. Similarly extraneous are suggestions that the Commission must review or regulate the Section 272 affiliate's prices in order for the accounting safeguards to be effective. Pricing of competitive interLATA services is not within the purview of accounting safeguards; rather, it should be governed by the free interplay of marketplace forces.[7] The Commission should reject these and other attempts to expand the accounting safeguards beyond their intended, proper purpose.

AT&T argues that the accounting safeguards are not effective to protect it unless the Commission completes access charge reform.[8] As the Commission has repeatedly confirmed, the accounting safeguards are effective in preventing cross-subsidy. The prices the BOCs and other LECs charge for access do not alter the Commission's repeated findings of effectiveness. Accounting safeguards do not regulate the prices of competitive services, and thus, they cannot be used to accomplish the IXCs' pricing objectives. Given that the Section 272 affiliates will be subject to the same access charges as the IXCs, on a nondiscriminatory basis, it is obvious that

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Telecommunications Association ("TRA") wants projections of future affiliate transactions data, such as anticipated costs, budgets and expected volume of transactions. This would enable it to size up its competition and anticipate the BOC affiliates' every move.

[7] See Joint Cost Order, ¶¶40, 115-117.

[8] AT&T at i, 3.

the IXCs cannot be disadvantaged.[9]

II. THE EXISTING ACCOUNTING SAFEGUARDS ARE EFFECTIVE.

A. General

Several commenters fail to appreciate the effectiveness of the accounting safeguards. First, consideration must be given to the objective that the commenter thinks the accounting safeguards should target. In some cases the commenter has chosen the wrong target, which explains the commenter's impression that the rules are ineffective. For example, AT&T questions the effectiveness of the accounting safeguards apparently based on its belief that accounting safeguards should protect AT&T from anticompetitive behavior and pricing practices in the interLATA market.[10] Since it believes the target is protection of interLATA competitors and regulation of prices, it is no wonder AT&T questions the effectiveness of the accounting

[9] See NYNEX at 15; USTA at 23. SBC does not address other arguments by commenters that are related to other pending proceedings rather than this NPRM. For example, some commenters present arguments in support of their positions concerning non-accounting safeguards, which belong in CC Docket No. 96-149, not in this proceeding. AT&T at 16; WorldCom at iv, 29-30. Another commenter addresses the allocation of network costs associated with video programming services, which is already the subject of CC Docket No. 96-112. California PUC at 7-8. Illustrative of the lengths to which RHC competitors are willing to go to bolster their positions in different proceedings, MCI implies that BOCs are not allowed to furnish "official services networks" to their affiliates. MCI at 31-32, 35. Contrary to the implication of these arguments, BOCs are clearly allowed to provide official communications services because this interLATA service was authorized under the MFJ and Section 271(f) indicates that activities authorized under the MFJ are not prohibited. See United States v. Western Electric, 569 F. Supp. 1057, 1101 (D.D.C. 1983). Even if SBC wished to fully address all of these tangential issues that are the subject of other proceedings, the page limitations would not permit a complete response.

[10] AT&T at 2-3.

rules.[11]

Some commenters suggest that the accounting safeguards must be strengthened because BOCs allegedly have a greater incentive and opportunity to cross-subsidize as a result of the new lines of business and allegedly "riskier ventures" that the 1996 Act allows.[12] In actuality, RHCs have been free to diversify for several years. Freedom from the interLATA and manufacturing restrictions of the MFJ merely opens up two additional competitive markets. Thus, the incentive and opportunity to cross-subsidize has not been altered by the 1996 Act. As far back as 1987 the Commission anticipated that LECs would make significant investments in nonregulated activities. In CC Docket No. 86-111, when the Commission designed the accounting safeguards, it considered that the LECs' investments would increasingly become a major source of nonregulated activity. In addition, the investment opportunities presented to the RHCs by the 1996 Act are no more risky than those they undertook under waivers of the MFJ or after the MFJ's non-telecommunications restriction was removed in 1987, such as real estate, office equipment, paging, etc. Contrary to commenters' allegations, the existing safeguards are entirely up to, or exceed, the task of preventing cross-subsidy at the expense of regulated

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[11] Similarly, when MCI argues that to be effective, the accounting safeguards should require the Section 272 affiliate to file its own CAM, MCI has also chosen a mistaken objective. MCI at 34. MCI believes the accounting safeguards should prevent cross-subsidy between two competitive services, i.e., competitive interLATA service and other nonregulated operations -- a goal the accounting safeguards were never intended to serve. MCI does not provide any rationale whatsoever for such an expansion of the accounting safeguards.

[12] See, e.g., APCC at 4; MCI at i-ii, 3-4; 16, 21.

ratepayers.[13]

B. Audits

MCI claims that a variety of audits conducted by the Commission staff demonstrate a need for stronger accounting safeguards.[14] On the contrary, the persistence, depth and intensity of the Commission's audit efforts show that the Commission is serious about monitoring and enforcement of its accounting safeguards. The Commission has performed audits of affiliate transactions in all BOCs. Out of the enormous volume of transactions reviewed by the Commission's auditors, only a small fraction have been questioned by auditors.

In fact, the Commission cited in the Computer Inquiry III Remand Proceeding the audit of NYNEX and the issues surrounding that enforcement proceeding that proved the efficacy of the existing affiliate transaction rules.[15] Further, the Commission has audited SWBT affiliate transactions in a Joint Staff Audit. Although issues from the SWBT audit remain under discussion, the audit report clearly expresses an ability to audit affiliate transactions based on the

[13] Certain commenters claims of ineffectiveness are based on a misunderstanding of the cost allocation rules. For example, arguing for structural separation of telemessaging, VoiceTel questions a number of principles and procedures of the cost allocation rules established in CC Docket No. 86-111. The Commission has repeatedly confirmed the adequacy of the cost allocation rules. VoiceTel's non-constructive criticism of the Joint Cost Rules belatedly questions assumptions upon which the Commission has relied for over eight years. Besides, the purpose of its comments is not to suggest any changes to the accounting safeguards, but to insist on structural separation -- a nonaccounting issue which is beyond the scope of this proceedings.

[14] In an apparent attempt to exaggerate its arguments, MCI discusses two audits that are unrelated to the cost allocation and affiliate transaction rules that are the subject of this NPRM. The NECA and lobbying audits were not audits of the accounting safeguards for nonregulated activities.

[15] Computer Inquiry III Remand Proceeding, 6 FCC Rcd 7571, ¶54 (1991).

rules and demonstrates that, although there are differences of opinion on the specific definition of certain cost allocation issues, for the vast majority of SWBT affiliate transactions audited there were no issues. Further, the items at issue represent less than one-half of one percent of SWBT's operating expense for the four-year audit period. As the Commission noted in the Computer Inquiry III Remand, "We conclude our comprehensive system of cost accounting safeguards has worked well and as strengthened, protects ratepayers against cross subsidization by the BOCs." What MCI characterizes as a failure to take enforcement action in reality constitutes vigorous enforcement. In any event, the Commission has not made any findings of wrongdoing as a result of any of the audits referenced by MCI.

III. SHARING OF ECONOMIES OF SCOPE DOES NOT REQUIRE ANY CHANGES.

WorldCom questions the Commission's attempt to preserve rather than destroy "the potential competitive benefits of the economies of scope that BOCs . . . could realize"[16] in connection with newly allowed activities.[17] WorldCom claims this goal is inconsistent with the Commission's general conclusions in the Interconnection Order (CC Docket No. 96-98) concerning the incumbent LECs' "economies of density, connectivity and scale." The two proceedings are entirely consistent in this regard. Through the 1996 Act, Congress did direct that incumbent LECs must share the advantage of some of their efficiencies with competing local service providers ("LSPs"). Except to the extent Congress imposed temporary separation

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[16] NPRM, ¶7.

[17] WorldCom at 6-8.

requirements, as well as other restrictions such as the nondiscrimination provisions, it did not deny incumbent LECs the benefits of their own efficiencies. In fact, the excerpt from the Interconnection Order quoted by WorldCom indicates that incumbent LECs should be permitted to "maintain operating efficiency." The LECs' network-related efficiencies can be shared with LSPs while at the same time preserving over-all efficiencies,[18] and, assuming these efficiencies are not stymied by excessive regulation, the incumbent LECs can use those efficiencies in a procompetitive manner in the new markets in which they have no foothold.

IV. SPECIAL COST ALLOCATION RULES ARE NOT NEEDED FOR INCIDENTAL INTERLATA SERVICES.

Commenters' claims that special cost allocation rules should be adopted for a BOC's integrated interLATA services[19] fail to recognize that existing rules are more than sufficient. Costs of incidental interLATA services will be allocated between regulated and nonregulated activities based on the hierarchy of cost allocation principles adopted in the Joint Cost Order.[20] Those Section 271(h) activities that are nonregulated for Title II accounting purposes will bear their proper share of joint and common costs pursuant to such Part 64 cost allocation principles. In addition, a BOC's regulated incidental interLATA activities which are subject to Title II regulation, Part 36 separations manual requirements and tariff process do not require additional

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[18] While the Interconnection Order will assure that the economies of scope are shared with LSPs, price cap regulation will assure they are shared with ratepayers of regulated services. See USTA at 5.

[19] AT&T at ii, 18-19; MCI at 14; WorldCom at 13-14; TRA at 26.

[20] PacTel at 10-12; US West at 6; USTA at 20.

cost allocation procedures.[21] Since the mechanisms used under existing rules will identify and allocate costs properly to nonregulated activities, special cost allocation rules are not necessary.

Some commenters favor the use of an approach similar to that used in the now defunct video dialtone ("VDT") regulations,[22] in which the costs of VDT service were allocated to separate "subsidiary records" pursuant to burdensome, detailed procedures prescribed in RAO Letter 25.[23] An approach that requires unnecessary, burdensome accounting details, such as RAO Letter 25's approach to VDT, can only serve as a stumbling block for a BOC's attempts to compete in the provision of these interLATA services. The 1996 Act authorized BOCs to begin these interLATA services at the time of enactment. It would be anomalous to construe the 1996 Act to require that barriers to BOC entry should be erected numerous months after enactment. Congress rejected the barriers to BOC entry into video programming when it repealed all of the VDT regulations and substituted a more flexible regulatory framework. The Commission should reject similar approaches that would serve as a choke upon, rather than a catalyst of, competition with the incumbent providers of interLATA services.[24]

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[21] BellSouth at 16; PacTel at 11; NYNEX at 14-15; US West at 6; USTA at 20.

[22] MCI at 14; WorldCom at 13.

[23] Accounting and Reporting Requirements for Video Dialtone Service, 10 FCC Rcd 6008 (1995), revoked, Report and Order, CC Docket No. 87-266, FCC 96-99, released March 11, 1996.

[24] A couple of commenters are in favor of classifying all costs other than those associated with local exchange and exchange access as nonregulated, as suggested in the NPRM. GSA at 4; TRA at 26. However, these commenters do not provide adequate justification for this approach other than conclusory allegations concerning prevention of cross-subsidy, misallocation or inadvertent misclassification. For example, GSA says this approach is necessary to protect

V. IMPOSITION OF MORE DETAILED, BURDENSOME AFFILIATE TRANSACTION RULES IS NOT JUSTIFIED.

Recognizing Congress' directive that the Commission minimize the burden of its regulations, the NPRM stated that "those urging that we adopt more detailed accounting safeguards than those in our current rules . . . bear a heavy burden of persuading us to adopt such safeguards."[25] Those commenters that advocate adoption of additional and more detailed affiliate transaction rules, such as those proposed in the NPRM, have not succeeded in meeting this heavy burden. More specifically, these commenters have not provided sufficient justification to outweigh the increased burden that would result from elimination of the prevailing price method and super-imposition of fair market value study requirements for affiliate services, as proposed in the NPRM.

In contrast, the LEC industry has provided extensive evidence of the intrusive, onerous and unnecessary burdens and the vast problems that the NPRM's proposed changes would create.[26] The additional costs of these more onerous affiliate transaction rules are especially baseless given that price cap regulation and other forms of incentive regulation such as price freezes and moratoriums will not permit LECs to raise regulated service rates to recover cost

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telephone ratepayers and to promote competition in the interLATA market. However, GSA does not provide any basis for its belief of the inadequacy of the existing rules, nor any rationale for reclassifying all costs other than those of local exchange and exchange access activities. As SBC explained in its Comments, this approach would clearly constitute a fundamental change in approach to cost allocation. SBC at 23.

[25] NPRM, ¶12.

[26] See, e.g., Ameritech at 14-17; BellSouth at 25-28, 32-34 & Appendix A; SBC at 30-38; USTA at 17.

increases attributable to improper affiliate transactions.[27]

Commenters supporting the NPRM's proposed affiliate transaction rule changes have not provided any basis to conclude that it is reasonable and consistent with minimizing the burden of regulation to throw out the objective prevailing price method in favor of a subjective process for estimating fair market value. Further, these commenters have not provided any evidence to substantiate NPRM's reasons for its proposed affiliate transaction rule changes. According to the NPRM, FDC alone is not adequate for services and must be supplemented by fair market value studies because otherwise, for example, LECs allegedly would purchase services from affiliates at a price in excess of fair market value. Commenters supporting more stringent affiliate transaction rules do not provide any factual support for the NPRM's conjecture. Unsupported conjecture would not be the proper basis for imposition of more burdensome regulation.

Rather than provide factual support for these proposed changes, the commenters merely echo the NPRM's unsupported concerns in an unconvincing fashion.[28] Mere repetition of a hypothesis does not establish its validity. There must be something to back it up. Further, in this case, the factual support must meet the heavy burden of showing that the benefits, in light of price cap regulation, outweigh the increased administrative costs, complexities and inefficiencies, such as those identified in the extensive analysis by Theodore Barry & Associates

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[27] See, e.g., Ameritech at 17; BellSouth at 27; PacTel at 40-42; NYNEX at 4-9; USTA at 4-12; US West at 29.

[28] AT&T at 14; MCI at 21-22; WorldCom at 25 ("This new approach will help reduce the economic incentives . . . to overprice the services the RBOC receives from the affiliate.")

submitted by BellSouth.[29]

In a hollow echo of the NPRM's conjecture, MCI claims that the existing "method for services, with its reliance on fully distributed cost, has created the incentive for LECs to purchase supplies and services from an affiliate even if the services could be obtained at a lower price on the open market."[30]

MCI questions the continuing validity of one of the original reasons for using FDC rather than fair market value, that is, that economies of scope and "cost savings could be achieved by centralizing certain functions."[31] MCI claims that, in hindsight, these advantages of using FDC alone had little validity. The remarkable weakness of MCI's argument is later revealed when MCI in effect argues that the BOC's economies of scope in joint marketing result in an unfair advantage to nonregulated affiliates if FDC alone is used.[32] It is ironic that in one breath MCI criticizes consideration of economies of scope as a motivation to use FDC and in the next breath it uses economies of scope as the reason to avoid using FDC for joint marketing services. In actuality, economies of scope and cost savings are achievable by centralizing functions and the existing rules assure that all sectors benefit from these efficiencies. The NPRM's proposal would deny Section 272 affiliates and other affected affiliates the right to share in these efficiencies.

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[29] BellSouth, Appendix A.

[30] MCI at 21.

[31] Id. at 22.

[32] MCI at 36.

Arguments against the use of FDC alone, such as those of MCI, assume a parent company would form an administrative subsidiary to perform a centralized service, such as human resources, just so it can incur more costs and be less efficient in the provision of that service than an unaffiliated vendor would be. Services are centralized to save money, provide a better affiliate service, and allow the BOC and its affiliates to provide the best possible customer service. Many times, as indicated in the Theodore Barry study submitted by BellSouth,[33] these are services for which no company would go to an outside vendor, such as corporate governance or complex planning or financial functions.[34]

If it is not a reasonable business decision for a company to outsource a strategic or corporate function, it is doubtful that a reasonable estimate of its value can be found on the open market.[35] The open market services will not be comparable in many respects to the service that an efficient, internal corporate member could provide. For these services, the simple, auditable fully distributed cost method provides the most practical, realistic and objective review model. It

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[33] BellSouth, Appendix A. The study uses the term "knowledge-based services" to refer to these non-routine and non-repetitive services that involve a "less clearly defined work product." Cf. PacTel at 25-26 (discussing "governance functions").

[34] One commenter's suggestion would take the NPRM's proposal to its most burdensome and unjustifiable extreme by requiring that, absent a waiver from the Commission, LECs could only use one of three methods of estimating fair market value. See TRA at 16-17. Not only would this require additional waste of resources, it would shackle the LECs' ability to conduct business with their affiliates efficiently and place the Commission in the role of an advisory board for affiliate purchasing decisions.

[35] Since the 1996 Act cannot be construed to require outsourcing of functions to third parties, the regulations under it should not be used to indirectly compel or coerce BOCs to outsource.

actually identifies the full attribution of cost to the service and to the affiliate benefitting from the service, and it is done on a real-time basis.

In fact, LECs previously have used FDC for affiliate joint marketing services and there is no reason to believe FDC is insufficient as a method of allocation. On the contrary, FDC allocates more than the incremental cost caused by the affiliate's joint marketing service requirements. It is thus more than adequate to prevent cross-subsidy concerns.

In contrast, there are ample reasons, identified by SBC and other commenters, for avoiding the use of subjective fair market value studies as a basis for valuing affiliate services.[36] As the Theodore Barry study and the experience of PacTel in California indicate, complexity and cost are sufficient reasons to rule out this method. For example, PacTel must perform fair market value studies for transactions exceeding $100,000 and the average cost per study is about $50,000.[37] Such oppressive requirements can cause productivity to plummet and drain the regimented entity of all of its efficiencies. It is also telling that proponents of fair market value did not construct a precise definition for determining fair market value. The reason is evident: it is not an objective measure that can be given a precise definition.[38]

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[36] SBC at 35-38 & n. 72; Bell Atlantic at 8; NYNEX at 21-26; Sprint at 13-14; USTA at 17-18; US West at 15.

[37] PacTel at 24.

[38] Estimated fair market value, by its own definition, is not an easily auditable or objective measure. Fully distributed cost can be traced through well established accounting guidelines. Estimated fair market value is just that, an estimate. It is no coincidence that when the NPRM asks for input concerning any more precise definitions for estimated fair market valuation techniques, even BOC competitors come up short on ideas. That is because the terms "precise" and "auditable" are incongruent with estimated fair market value. Even if a comparable service

While the American Public Communications Council ("APCC") is among those that favor more stringent accounting safeguards, it recognizes the "inherent problems associated with determining fair market value."[39] One of the APCC's reasons for advocating the retention of the prevailing price method is that "it is more objective . . . than fair market value."[40] Thus, even those advocating more stringent accounting safeguards recognize the inherent problems in using estimated fair market value and the relative advantages of the prevailing price method.

VI. THE COMMISSION SHOULD NOT ELIMINATE OR MODIFY THE PREVAILING PRICE METHOD.

LECs as well as other non-LEC commenters, such as AT&T, also favor retention of the prevailing price method. These commenters recognize that a prevailing price can be verified by actual third party purchases of the BOC's or its affiliate's products and services. For example, AT&T states as follows:

> Although the prevailing company price method, like all of the valuation methods, is flawed and subject to abuse, the fact that such prices are determined in a market does provide some external discipline on the BOCs' and their affiliates' pricing methods. Rather than eliminating the method altogether, the Commission should modify the rules so that the prevailing company price method is available only if the affiliate sells a substantial percentage, by quantity, of that product line to

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exists outside of the BOC or its affiliate, the likelihood is there will not be one price, but a range of prices. These will vary based on quality, quantity, reputation of the supplier and even location (i.e., supply and demand). This is where the unending debate begins. Even if the BOC spends millions of dollars to have studies performed, the end result is a subjective and imprecise answer.

[39] APCC at 28.

[40] Id. at 27-28.

nonaffiliated customers.[41]

Thus, even from the viewpoint of the BOCs' largest competitor, elimination of prevailing price should not even be the issue on the table. Instead, at most, the issue is whether use of prevailing price should be limited. This issue was debated extensively in CC Docket No. 93-251 and based on that record, the Commission should find that the existing standard is proper because it requires substantial transactions with third parties to establish a prevailing price. The Commission need not establish any arbitrary thresholds such as those proposed in the Affiliate Transaction NPRM. In its comments in that proceeding, AT&T argued that, in view of effective competition for its services and the price cap system under which AT&T operated, the affiliate transaction rules were no longer necessary because AT&T could not use affiliate transactions to improperly inflate its interexchange prices.[42] However, AT&T continued, if the affiliate transaction rules continued to apply to AT&T, the existing rules, rather than more restrictive rules, should apply. Specifically, AT&T argued that

> [the] 75 percent threshold [proposed in the Affiliate Transaction NPRM] is far higher than any economic principles or theory would justify:
>
> > "A market price is established if any significant group of market participants engages in arm's length transactions at that price. In particular, suppose that a significant group of customers buys a good or service at a certain price from an unregulated affiliate of AT&T. These transactions provide evidence that AT&T's regulated operations would have to pay at least that same price if they relied on external supply. Indeed, the next best source of

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[41] AT&T at 15.

[42] AT&T Comments, CC Docket No. 93-251, filed December 10, 1993, at i-ii, 4-13.

supply, other than AT&T, may be at a higher price."[43]

The regulation that AT&T advocated for itself in 1993 is entirely appropriate and should be sufficient in the current environment for BOCs and other LECs, especially in view of price cap regulation and the 1996 Act's pro-competitive, deregulatory objectives. The approach to prevailing price advocated by AT&T would minimize the burden of regulation by not imposing an arbitrary threshold.[44]

AT&T suggests another limitation in the use of the prevailing price method. In response to the NPRM's concern that the prevailing price may not be a reasonable valuation method due to the differences between affiliate and third party transactions, AT&T argues that BOCs should not be allowed to deduct a discount from the prevailing price to reflect the allegedly lower marketing and transaction costs incurred in affiliate transactions compared to third party transactions.[45] Because any differences in costs between affiliate and third party transactions are minor, SBC believes it would be a wasted effort to attempt to quantify the costs avoided in furnishing such services to affiliates. Given that the costs avoided are minor, the prevailing price charged to third parties in comparable transactions is a reasonable valuation method. Assuming the affiliate and third party transactions are otherwise comparable, the minor differences in costs

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[43] Id. at 18 (quoting "The Absence of a Public Policy Rationale for Applying Affiliate-Transaction Rules to AT&T," prepared by Dr. John Haring and Dr. Jeffrey H. Rohlfs, December 10, 1993).

[44] TRA at 26-27.

[45] AT&T at 14.

do not cause such transactions to cease being comparable.

VII. THE ACCOUNTING SAFEGUARDS SHOULD NOT REQUIRE A BOC TO DISCRIMINATE AGAINST ITS SECTION 272 AFFILIATE.

The Commission must be careful to avoid adoption of accounting safeguards that would require a BOC to discriminate against its Section 272 affiliate compared to that affiliate's competitors. For example, AT&T argues that all components of telecommunications services should be calculated based on long-run incremental cost, and yet, advocates affiliate transaction rules and other regulations that would assure that such components are not available on the same terms to a Section 272 affiliate.[46] Adoption of such an approach would be contrary to Section 272(c) and (e) because it would require the BOC to "discriminate between that company or affiliate and any other entity in the provision . . . of services [and] facilities."[47] Such rules would place the Section 272 affiliate at an additional competitive disadvantage compared to its lightly regulated (or nonregulated) peers.

To the extent interconnection, network elements and other services are required to be made available to IXCs at a price determined based on incremental cost, such prices should be equally available, on a nondiscriminatory basis, to the Section 272 affiliate.[48]

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[46] Some of the regulations sought by AT&T are the subject of the non-accounting safeguards rulemaking, CC Docket No. 96-149. See SBC Comments, CC Docket No. 96-149, filed August 30, 1996, at 9-10.

[47] 47 U.S.C. §272(c)(1).

[48] See SBC at 40-41 & n. 82.

VIII. THE COMMISSION SHOULD REJECT SUGGESTIONS TO IMPOSE ADDITIONAL DETAILED ACCOUNTING SAFEGUARD OR AUDIT REQUIREMENTS.

A few commenters suggest a variety of additional requirements, but these commenters clearly fail to satisfy the "heavy burden" standard that the NPRM indicated it would apply to any such proposals. For example, APCC suggests that CAM filings should include a variety of additional details that are entirely unnecessary.[49] In addition, adoption of any of APCC's changes would be contrary to the deregulatory intent reflected in the 1996 Act's easing of the burden of CAM filings. The existing CAM filings already contain more than sufficient information to enable the Commission and independent auditors to audit the LECs' compliance with the accounting safeguards.[50] Requiring more detailed CAM filings, as suggested by APCC, or other detailed disclosures suggested by other commenters, does not limit the burden of the accounting safeguards to only those requirements that are necessary to accomplish their

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[49] APCC at 15-16. APCC also suggests other unnecessary changes to the accounting safeguards. For example, it proposes illogical changes to the marketing allocator based on an unfounded belief that nonregulated operations in the BOC and its affiliates are not receiving enough marketing or advertising costs required by such operations. This is simply not true. Given that corporate image advertising is allocated based on previously identified directly reported and assigned costs, then to the extent that there is significant product specific advertising those new nonregulated products and services receive a proportionally higher percentage of the corporate image advertising cost allocation. That was the intent of the marketing rules as written, and that, in fact, is the result of the normal application of the rules. APCC's proposal of an arbitrary 50% allocation is not appropriate, and in fact could under-allocate costs to the nonregulated operations, particularly in the start-up phase where direct product level advertising is usually quite intense.

[50] Existing CAM filings already include detailed data concerning nonregulated activities, incidental regulated activities, affiliate transactions, cost pooling and allocation methodologies (on an account-by-account basis) and time reporting methods. A typical annual CAM filing is over 200 pages.

objectives. The Commission should narrowly tailor its accounting safeguards to accomplish only that which is necessary to protect ratepayers of LECs' regulated services.

The Commission should likewise reject pleas to establish a litany of rules for conducting audits. Compliance with Generally Accepted Auditing Standards ("GAAS") should be the only requirement other than those in existing rules or expressly required by explicit provisions of the 1996 Act. Suggestions to the contrary notwithstanding, the audits authorized by the 1996 Act, such as the biennial audit required by Section 272(c), were not intended to create a new auditing bureaucracy. In a Section 272 audit, the independent auditor only needs to confirm that the BOC has complied with Section 272, its implementing regulations and its separate accounting requirements. It is a narrowly defined audit to be conducted by an independent audit firm on a biennial basis. In fact, the content and scope of the audit report should be determined by the independent auditor in conformance with the standards (i.e., GAAS) promulgated by the American Institute of Certified Public Accountants. Instead of attempting to micro-manage the audit process, the Commission should leave the details of the accounting procedures to these accounting experts, under their professional guidelines.

IX. THE COMMISSION MUST NOT ADOPT SUGGESTED RULES THAT ARE CONTRARY TO THE 1996 ACT.

Some rules suggested by commenters cannot even be considered because they would contradict the 1996 Act. For example, APCC proposes a rule that would require assessment of a royalty fee for the use of the "LEC's name, reputation, and logo."[51] Congress recognized that the

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[51] APCC at 18-21.